IN THE

Supreme Court of the United States

OCTOBER TERM, 1944.

No. .....

CHAPMAN PRICE STEEL COMPANY, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I. OPINIONS BELOW.

The opinion of the Circuit Court of Appeals for the Seventh Circuit (R. 44-48) is reported in 146 Fed. (2d) 189. The Memorandum Findings of Fact and Opinion of The Tax Court (R. 26-27) are not included in the official reports of that Court, but are unofficially reported as CCH Dec. 13,472 (M).

II. JURISDICTION.

Jurisdiction of the Supreme Court is invoked under Section 240(a) of the Judicial Code, as amended; (U. S. C. A. Chap. 28, Sec. 347). The decision of the Circuit Court of Appeals was rendered on December 15, 1944. The time for

filing the petition for writ of certiorari was extended to and including May 14, 1945 by order of an Associate Justice, entered March 1, 1945. The controversy involves corporate income taxes sought to be collected from the Petitioner under the provisions of the Revenue Act of 1938 (52 Stat. 447).

III. STATEMENT OF CASE.

The Petitioner, an Indiana corporation, duly filed its corporate income return with the Collector for the District of Indiana for the calendar year 1939. On this return, Petitioner took a "dividends paid credit" of $3718.46 under Section 27 of the Revenue Act of 1938 on account of a deficit in the accumulated earnings and profits existing as of the close of the preceding calendar year. This deficit was directly the result of the charge to said account on December 31, 1920 of a stock dividend declared and paid by Petitioner on that date in the amount of $240,456.00. This stock dividend was paid in common shares upon common shares, there being but the one class of stock outstanding (R. 18). Petitioner claimed the right to this deduction under the specific terms of said Section 27 of the Revenue Act of 1938, and under the provisions of Section 201 of the Revenue Act of 1918 (40 Stat. 1057) which latter section defined dividend distributions to include stock dividends and declared any such distribution should be deemed to be a distribution of earnings and profits. Petitioner also relies upon the decision of the Circuit Court of Appeals for the Second Circuit in *Estate of Bedford* v. *Commissioner*, 144 Fed. (2d) 272, and other decisions of said Circuit cited therein. The Respondent disallowed the "dividends paid credit" and issued a deficiency notice against Petitioner. An appeal was filed with The Tax Court and the cause there tried on a stipulation embodying all facts. It was therein agreed that if Petitioner was entitled to such a credit, the correct amount thereof would be $3,404.80 (R. 18). It was the Respondent's position before The Tax Court, and the Circuit Court

of Appeals as well, that the stock dividend did not distribute earnings, and when the amount thereof was restored to the earned surplus account, there was in fact no deficit therein and thus no "dividends paid credit" was allowable.

The Tax Court sustained the Respondent, upon the reasoning that the stock dividend did not distribute earnings, relying on the decision in *Eisner* v. *Macomber*, 252 U. S. 189, that stock dividends were not taxable income to the recipient shareholders, and upon The Tax Court's previous decision in *Estate of Bedford*, 1 T. C. 478.

Upon appeal to the Circuit Court of Appeals for the Seventh Circuit, the decision of The Tax Court was affirmed on the reasoning adopted by The Tax Court and upon the further ground (the Bedford decision of The Tax Court having been reversed) that *Eisner* v. *Macomber* struck down not only those portions of the Revenue Act of 1916 which attempted to tax stock dividends as income, but also the further provision of the 1918 Act which defined dividends to include distribution of stock dividends.

IV. QUESTIONS PRESENTED.

(a) Did the declaration and distribution of the stock dividend on December 31, 1920 constitute a distribution of earnings?

(b) Did the decision in *Eisner* v. *Macomber* strike down the definition of "dividend" set out in Section 201 of the Revenue Act of 1918?

V. STATUTES INVOLVED.

The pertinent provisions of Section 201 of the Revenue Act of 1918 and Section 27 of the Internal Revenue Code (a part of the Revenue Act of 1938), and of Article 27 (a) 2 of Regulations 101 are set out in full in the Appendix of this brief.

VI. ARGUMENT.

A. The decision below is in conflict with the decision of the Second Circuit Court of Appeals.

B. This cause involves an important question of Federal tax law, which should be settled by this Court.

C. The conclusions of the Courts below are erroneous and contrary to the established principles of statutory construction.

Conflict in Decisions.

At the very outset, counsel for Petitioner state they do not attack nor do they seek to re-argue the conclusion reached by this Court in *Eisner* v. *Macomber*, 252 U. S. 189, viz: that stock dividends are not taxable income to the shareholder recipients. It is the position of counsel that the Eisner decision never considered or passed on those portions of Section 201 of the Revenue Act of 1918 which are pertinent and decisive of the issues herein.

The decision of the court below in this cause is in direct conflict with decisions of the Circuit Court of Appeals for the Second Circuit in *Estate of Bedford* v. *Commissioner*, 144 Fed. (2d) 272; *Commissioner* v. *Quackenbos*, 78 Fed. (2d) 156; *Patty* v. *Helvering*, 98 Fed. (2d) 717; and *DeNobili Cigar Co.* v. *Commissioner*, 143 Fed. (2d) 436. This is clearly evident from the following quotation from the Bedford decision (p. 273).

> "We held in Commissioner vs. Quackenbos, 78 F. (2d) 156; Patty vs. Helvering, 98 F. (2d) 717; and DeNobili Cigar Co. vs. Commissioner, 143 F. (2d) 436, that when earnings are once capitalized by the issue of stock dividends they are no longer earnings but capital, except in cases where the purpose of the transaction is not an honest business purpose but one to avoid taxation."

A more extensive discussion appears in the Opinion in *Patty* v. *Helvering, supra.*

Important Question of Federal Tax Law.

While the question in this cause arises under the Revenue Act of 1918, the decision deals with a principle of taxation which is still very important to all corporate taxpayers who declared and paid stock dividends during the period from February 24, 1919 to November 23, 1921, while that Act was in effect. The language in Section 201 of this Act was eliminated by the Revenue Act of 1921 (42 Stat. 227) and has not appeared in any subsequent Act. The question also has arisen and will arise in many cases involving liquidation as was true in *Patty* v. *Helvering, supra,* and in cases where it is necessary to distinguish between the payment of a dividend and a distribution in partial liquidation. Cf. *Estate of Bedford* v. *Commissioner, supra.*

Decision Below is Erroneous.

The vital and important fact is that the stock dividend in question was made a distribution of earnings by Section 201 of the Revenue Act of 1918, quoted in full in the Appendix to this Brief. We paraphrase the material words of subsection (a): dividend means any distribution made by a corporation, whether in cash or in other property or in stock of the corporation; also of subsection (b): any distribution shall be deemed to have been made from earnings or profits unless all earnings and profits have already been distributed.

This statutory declaration follows the established rule of corporate law.

> "Earnings of a corporation remain such until the intent to make them a part of the permanent property of the corporation is in some way manifest.
>
> "Earnings may be divided in two ways: (1) by declaring and paying a cash dividend; or (2) by declaring and issuing a stock dividend."
>
> *Sexton* v. *Percival,* 189 Ia. 586 (Par. 3 and 4 of Syl.).

> "A dividend is that portion of the profits and surplus funds of a corporation which has actually been set apart by a valid resolution of the Board of Directors, or by the shareholders at a corporate meeting for distribution among the shareholders according to their respective interests in such a sense as to become segregated from the property of the shareholders distributably. It is a matter of no difference whether the dividend is declared in stock or paid in cash and thereafter converted into stock by the shareholders; in either event it is a distribution of the surplus profits of the corporation."
>
> *Rose* v. *Barclay*, 191 Pa. St., 594 (Syl.).

Nor does Section 27 of the Internal Revenue Code, or Regulations issued by Respondent interpreting the same, exclude stock dividends from the determination of a deficit in accumulated earnings and profits for purposes of a "dividends paid credit". (See Appendix.) This credit is composed of (a) the basic surtax credit, (b) the dividend carry over, (c) any deficit in accumulated earnings and profits, and (d) amounts used or set aside to pay or retire indebtedness. The word "deficit" is used in this section without definition or limitation, while other subsections specifically define and fix methods of computation for (a) and (b). It is important that in defining "basic surtax credit" subsection (i) provides:

> "(i) Nontaxable Distributions. If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, such part shall not be included in computing the basic surtax credit."

The Respondent in Regulations 101, Article 27(a)2 places no limitation upon the method by which the deficit in earned surplus account arises. We quote only the material portions:

"Included in the dividends paid credit is an amount equal to the excess of any deficit in accumulated earnings and profits * * * *.

"A deficit in accumulated earnings and profits can arise only out of the operation of the business at a loss and cannot be caused by distributions to shareholders in excess of the amount of accumulated earnings and profits. If distributions are made to shareholders out of accumulated earnings and profits, however, such distributions may contribute to the creation of a deficit by so exhausting the accumulated earnings and profits that they are incapable of absorbing a loss thereafter resulting from the business."

Nowhere is the taxability of the distribution made the test of inclusion or exclusion in computations of a "deficit in accumulated earnings or profits".

Nor is the decision in *Eisner* v. *Macomber, supra,* to the contrary. Section 2 of the Revenue Act of 1916 was before this Court in that case. The 1916 Act contained no provision similar or in any way analagous to subsections (a) and (b) of the 1918 Act. The decision in that case held the distribution of a stock dividend did not constitute income within the 16th Amendment to the Constitution even though Section 2 of the 1916 Act declared such distributions to be taxable income. We point out that the question in the present cause is not taxability but the legislative grant of a credit to reduce taxable income. Credits and exemptions are always a matter of legislative grace. Thus when no limitation upon or method of computation of the deficit in accumulated earnings and profits is prescribed either in Section 27 or the Regulations pertaining thereto, it is submitted the term "deficit" is to be given its natural, plain, ordinary, and commonly understood meaning. *Miller* v. *Robertson,* 266 U. S. 243. The term "deficit" is unambiguous and any attempt by Respondent to enlarge the same by Regulation would be beyond his power. *Koshland* v. *Helvering,* 298 U. S. 441.

CONCLUSION.

It is therefore respectfully submitted that this cause is one calling for the exercise by this Court of its supervisory powers of review, and a writ of certiorari should be granted as prayed for.

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